

THE TREASURY DEPARTMENT'S ENFORCEMENT PROPOSALS FOR ABUSIVE TAX AVOIDANCE TRANSACTIONS

EXECUTIVE SUMMARY

The Treasury Department is announcing an initiative that will give the Treasury Department and the IRS the tools needed to combat abusive tax avoidance transactions. The mind-numbing complexity of the Internal Revenue Code underlies these transactions. While the vast majority of taxpayers and their advisors do their best to comply with the law, the Code's multitude of rules creates opportunities for those who would seek to reduce improperly their tax liabilities. Fundamental fairness requires that questionable transactions be disclosed and evaluated so that all taxpayers bear their fair share of taxes.

Transparency – insuring that questionable transactions are disclosed and subject to IRS scrutiny – is at the core of the Treasury Department's initiative. The current enforcement regime, which includes the temporary regulations that were issued in February 2000, provides for the disclosure by taxpayers of potential abusive tax avoidance transactions, and the registration of these transactions and the maintenance of investor lists by promoters. The Treasury Department and the IRS' experience with this current enforcement regime – and especially with the return disclosures filed in fall 2001 – has been disappointing and points to the apparent willingness by taxpayers and promoters to interpret and manipulate the rules to avoid disclosure.

Clearer rules and stiffer penalties are needed to ensure transparency. The Treasury Department's initiative will create a series of clear, mutually-reinforcing rules for disclosure, registration, and list maintenance. These rules will be easier for taxpayers and their advisors to apply, and harder for those who seek to avoid disclosure to manipulate. The Treasury Department also is proposing new and substantial penalties, and significant increases to existing penalties, for those taxpayers and promoters who fail to obey these rules.

The Treasury Department's initiative will build upon ongoing Treasury Department and IRS efforts to combat abusive tax practices. Recent actions have focused on both individual and corporate tax avoidance transactions, and on both taxpayers and promoters.

- The IRS announced in December 2001 a limited-time program to encourage disclosure of questionable transactions. A taxpayer who discloses a transaction, and who identifies all promoters of the transaction, will avoid accuracy-related penalties. The taxpayer, however, will still be liable for interest on any underpayment of tax. To date, almost 150 transactions have been disclosed, including many that the IRS already has identified as tax avoidance transactions. Along with this disclosure initiative, the IRS issued penalty guidelines for all tax avoidance transactions that require the full, fair, and consistent consideration of penalties.

- The Treasury Department and the IRS are working closely together to streamline the evaluation of transactions, including the determination of whether a transaction should be identified as a listed (i.e., tax avoidance) transaction for taxpayer disclosure purposes.
- The Treasury Department and the IRS are working to re-deploy additional resources to deal with tax avoidance transactions and have increased their coordination with the Department of Justice.
- The IRS is working actively to obtain transaction and investor information from some 30 promoters of tax avoidance transactions. These efforts have and will continue to include the use of judicial summonses for those promoters who prove reluctant in providing this information.
- The IRS, in coordination with the Department of Justice, is working to shut down the promoters of abusive tax schemes directed primarily at individuals and small businesses. Courts already have issued six injunctions, and a number of additional cases are pending.
- The IRS is investigating a major abusive tax avoidance scheme used by individuals to evade U.S. tax by placing assets in banks located in foreign tax havens. Thousands, and potentially tens of thousands, of individuals are participating in these schemes. Through judicial summonses, the IRS is working to identify these individuals and is in the process of initiating enforcement action, including audits and criminal actions.
- Treasury and the IRS recently published a notice warning taxpayers that the IRS will challenge transactions using a loan assumption agreement to claim an inflated basis in assets acquired from another party.
- Treasury and the IRS recently published a notice warning taxpayers that the IRS will challenge transactions improperly shifting basis from one party to another.
- Treasury and the IRS recently published a notice announcing Treasury's intention to promulgate regulations that prevent the duplication of losses by a consolidated group.
- Treasury and the IRS recently published final regulations on hedging transactions that prevent employers from deferring tax on income from investments used to fund deferred executive compensation.
- Treasury is actively pursuing, and has had remarkable success in obtaining, tax information exchange agreements with offshore financial centers. These agreements allow us to pursue information on civil and criminal tax evaders even when countries have bank secrecy laws.

The Treasury Department recognizes that more must be done to curb abusive tax practices, and this initiative, by establishing clear rules for transparency and stiff

penalties who attempt to avoid scrutiny, will allow the Treasury Department and the IRS to devote more resources to evaluating and addressing questionable transactions.

Administrative Actions - Highlights

- Expand Disclosure – Individuals, partnerships, S corporations, and trusts, in addition to corporations, will be required to disclose questionable transactions. Current rules cover only corporations.
- Expand and Unify the Definition of a Reportable Transaction – Current rules contain different definitions of a transaction for disclosure, registration, and list maintenance. A single, clear definition will be established that will curtail the apparent manipulation of the current rules by some taxpayers and promoters.
- Impose Accuracy-Related Penalties for Reportable Transactions that are not Disclosed – Current rules permit taxpayers to assert as a defense to the accuracy-related penalty that they have received a tax opinion regarding that transaction. Amended regulations will prohibit this defense with respect to undisclosed reportable transactions and will increase the penalty in certain cases. These amended regulations also will address undisclosed transactions that are based on the invalidity of a regulation.
 - If a listed transaction is not disclosed, a strict liability accuracy-related penalty of 25% will be imposed on any underpayment resulting from the transaction regardless of the amount of the understatement. This would be in addition to a new \$200,000 penalty for the failure to disclose a listed transaction. Legislative changes would be required for these new and increased penalties. See attached penalty chart.
 - If a non-listed reportable transaction is not disclosed, the existing defenses to any accuracy-related penalty (e.g., reasonable cause, substantial authority) will not be available for any underpayment resulting from the transaction.
 - If a transaction based on the invalidity of a regulation is not disclosed, a strict liability accuracy-related penalty will be imposed on any underpayment resulting from the transaction regardless of the amount of the understatement.
- Broaden the Registration and List-Maintenance Requirements – The persons responsible for registering transactions and maintaining investor lists will be broadened to insure that this information is available to the IRS. The list-maintenance requirements will be mandatory for all material participants in the promotion of a reportable transaction.
- Establish Standards for Legal Opinions – The Treasury Department and the IRS are revising the proposed rules in Circular 230 governing the legal opinions used to market and support tax avoidance transactions.

Legislative Proposals – Highlights

- Impose a Penalty on the Failure to Disclose Reportable Transactions – Significant new penalties will apply to the failure to disclose reportable transactions. No penalty currently exists.
- Increase the Penalty for the Failure to Timely Turn Over Investor Lists – The existing penalty will be significantly enhanced, particularly to address promoters who delay in providing the IRS with required information.
- Require Corporations to Publicly Disclose to Shareholders Penalties for the Failure to Disclose Listed Transactions and Accuracy-Related Penalties Resulting from Listed Transactions that are not Disclosed – Corporations would be required to disclose publicly the payment of a penalty for failure to disclose a listed transaction or an accuracy-related penalty imposed as a result of an undisclosed listed transaction.
- Permit Injunction Actions against Promoters who Repeatedly Disregard the Registration and List-Maintenance Requirements – The Government will be permitted to enjoin the most egregious promoters of abusive tax avoidance transactions, as it is doing currently with promoters of tax scams directed primarily at individuals and small businesses.
- Impose a Penalty for the Failure to Report an Interest in a Foreign Financial Account – A new civil penalty will be imposed on the failure to disclose foreign financial accounts, which often are used in tax avoidance transactions.
- Expand Section 901(k) – Additional restrictions will eliminate any additional efforts to traffic in foreign tax credits.
- Curb Abusive Income-Separation Transactions – New rules will curtail tax avoidance transactions that separate the periodic income stream from an underlying income-producing asset in order to generate an immediate tax loss for one taxpayer and the conversion of current taxable income into deferred capital gain for another.